The SEC's Recent Actions With Respect to Auction Rate Securities

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Chairman Frank, Ranking Member Bachus, and Members of the Committee:

Thank you for the opportunity to testify today about the Commission's efforts in response to the freezing of the auction rate securities market in mid-February 2008.

I'd like to start with the big picture: Thanks to the collective efforts of federal and state law enforcement and securities regulatory officials, tens of thousands of investors are having billions of dollars of liquidity restored to them in very short order. This relief is virtually unprecedented in type, magnitude and timing.

Our actions were necessary because broker-dealer firms that underwrote, marketed and sold auction rate securities (ARS) misled their customers. Through their sales forces, marketing materials, and account statements, firms misrepresented to their customers that ARS were safe, highly liquid investments that were equivalent to cash or money market funds. As a result, numerous customers invested in ARS their savings and other funds they needed to have available on a short-term basis. These firms failed to disclose the increasing risks associated with ARS, including their reduced ability to support the auctions. By engaging in this conduct, those firms violated the Federal securities laws, including the broker-dealer antifraud provisions.

Due to the collective efforts of the regulators, which have resulted in several settlements-in-principle, investors in ARS at a number of firms, including retail customers, small businesses, and charitable organizations, will have the opportunity to receive 100 cents on the dollar on their investments, and within short time frames. Customers who accept these offers will receive all interest payments or dividends and will be given the opportunity to sell their ARS at par, without a loss. Since the ARS market seized up in mid-February 2008, the need for investors to obtain liquidity with respect to their ARS holdings has been of paramount importance to the SEC, as well as the need to ensure the integrity of the markets. Through the Division of Enforcement's settlements-in-principle with UBS, Citigroup, Wachovia, and Merrill Lynch, over $40

billion in liquidity is expected to be made available to tens of thousands of customers in the near future.

The settlement process also featured a tremendous level of cooperation by state and federal regulators to arrive at early and comprehensive solutions to a market-wide problem. The settlements-in-principle provide quick relief to the investors most in need, and also mark a clear path forward to ultimate resolutions benefiting additional investors. And our efforts continue.

Auction Rate Securities and the SEC's Investigations and Examinations

ARS are municipal and corporate bonds, as well as preferred stocks, with interest rates or dividend yields that are periodically reset through auctions, typically every 7, 14, 28, or 35 days. Auction rate bonds are usually issued with maturities of 30 years, but the maturities can range from five years to perpetuity. ARS were an attractive financing vehicle for issuers because they are essentially long-term obligations that re-price frequently using short-term interest rates, which are typically lower than long-term interest rates. For investors, ARS offered slightly higher returns than cash products, such as money market funds or certificates of deposit. Historically, ARS investors generally were large institutions, but several years ago many retail customers entered the market when financial services firms reduced the minimum investment to $25,000.

ARS, which were first developed in 1984, had by early 2008 grown into a $330 billion market. Until the ARS market froze in mid-February 2008, auction failures were extremely rare, and, accordingly, the market was highly liquid.

The ARS market encountered significant problems during early 2008. While it is difficult to identify every reason why the ARS market froze, we believe that there were several contributing factors. One factor is the significant increase in the size of the ARS market, which had grown to $330 billion by the time of the freeze. This larger market required the firms to find more and more customers to bid in the auctions. An additional reason for the market seizure is the rating agencies' downgrades of the monoline insurers (e.g., Ambac Financial Group Inc, and MBIA Inc.), which provided insurance for many ARS to ensure that holders would receive repayment of their principal if the issuer defaulted. These downgrades resulted in the loss of customers willing to invest in ARS. Another factor that contributed to the freeze is the sub-prime mortgage and credit crisis that unfolded throughout the second half of 2007, which limited the firms' ability to support the auctions with their own capital. In fact, firms stopped supporting the auctions in mid-February 2008, and the entire market froze in a matter of days. The securities became illiquid, leaving tens of thousands of customers unable to sell their ARS holdings.

The SEC immediately responded to the market failure in multiple ways. The SEC's Division of Enforcement began investigating possible securities law violations. Working with our Office of Investor Education and Advocacy, we deployed tremendous resources to discover and identify potential wrongdoing. In March 2008, Enforcement

staff began serving voluntary requests for information on 26 broker-dealer firms. The requests asked for information relating to, among other things: investor and issuer complaints; the number of failed auctions that the firms managed; the reasons why the firms stopped supporting the auctions in mid-February; the dollar amount of ARS held by the firms' customers; ARS marketing materials; and documents relating to the liquidity of ARS. In addition to these enforcement efforts, SEC examiners initiated examinations of numerous broker-dealer firms.

We also quickly interviewed numerous investors and other market participants, including employees of broker-dealers and issuers. We also established a dedicated email box to receive investor complaints. Since mid-February, the Commission has received more than 1,000 complaints from investors concerning approximately 50 broker-dealer firms. Investors reported such things as their brokers had led them to believe they were investing in safe and liquid investments – cash equivalents – and when the market froze, that they could not access their funds for important short-term needs, such as a down payment on a house, medical expenses, college tuition, taxes, and for some small businesses, payroll.

The Enforcement Division formed a nationwide ARS Working Group to coordinate the various investigations and to facilitate the sharing of information and experience among staff at Headquarters and our Regional Offices. We have had, and continue to have, teams of lawyers, accountants, and examiners working on ARS investigations and examinations throughout the country. All told, we have dozens of professionals working to gather the facts.

In an effort to conduct investigations as quickly as possible and avoid unnecessary duplication, we also coordinated our efforts with other regulators, including FINRA, the Office of the New York Attorney General (NYAG), and the North American Securities Administrators Association (NASAA). By way of example, when NASAA announced on April 17, 2008, the formation of its ARS task force chaired by the Massachusetts Securities Division, senior SEC Enforcement staff immediately contacted Secretary Galvin's office offering to coordinate and cooperate on our respective investigations. We had similar contacts with the NYAG and FINRA early in our investigation. The SEC's staff also granted access to its investigative files to every regulator that submitted a request for them.

Based on our analysis of the information received from broker-dealers, SEC Enforcement staff identified several firms that were the largest participants in the ARS market and the firms about which we had received the largest number of complaints. Our investigative efforts focused on those firms.

The two largest ARS market participants were Citigroup and UBS. These firms became a primary focus of the investigations being conducted by the SEC's Enforcement staff and our fellow regulators. In late April, Enforcement staff agreed to coordinate investigative efforts with the NYAG regarding Citigroup, UBS, and other firms. In early

May, we had conversations with state regulators from Texas regarding Citigroup, and subsequent discussions with other state regulators regarding other firms.

As with any enforcement matter, the Division of Enforcement recommends taking action only after investigating the relevant facts and concluding from the evidence that a violation of the federal securities laws has likely occurred. Early on in the ARS investigations, Enforcement staff had preliminary discussions with both Citigroup and UBS about the possibility of a global resolution with the SEC and other regulators. In order to fairly and rationally discuss any proposed resolutions, however, Enforcement staff first had to ascertain the dimensions of the problems. We had to understand the facts and evidence, and develop a fair and rational framework for resolution.

In conducting the ARS investigations, Enforcement staff was acutely aware that time was of the essence and we expedited our efforts accordingly**.** In early summer, Enforcement staff along with NYAG staff embarked on an aggressive schedule of on-the-record investigative testimony of employees of Citigroup and UBS, including persons on the firms' respective ARS desk and salespeople who sold ARS to the firms' customers. Our efforts to conduct fast and thorough investigations were made against the backdrop of an ARS market that was still frozen and during a period when we continued to hear from investors about the hardships resulting from illiquidity in the ARS market.

Our investigative record shows that both firms made material misrepresentations and omissions to their customers in connection with their marketing and selling of ARS. The SEC's investigation further shows that, until the ARS market seized, Citigroup and UBS marketed ARS to their customers as safe and highly liquid investments with characteristics similar to money market instruments. These firms misleadingly characterized ARS as "cash alternatives" or "money market and auction instruments." These representations were made in oral communications from brokers to customers and on customer account statements. Further, the investigation showed that the firms failed to adequately disclose to customers the liquidity and investment risks of ARS. Among other things, the firms failed to disclose that in late 2007 and early 2008, ARS liquidity risks had materially increased, when the firms knew that there was an increased likelihood that they and other broker-dealers would no longer support the auctions.

The Division of Enforcement's Settlements-In-Principle Provide Liquidity Solutions for Investors

After SEC investigators established facts indicating that UBS and Citigroup had engaged in violations of law, the Enforcement staff began discussions with the firms regarding resolution of our investigations, while continuing to gather additional evidence and facts.

In its initial discussions with the firms, the Enforcement staff emphasized that restoring liquidity to the tens of thousands of ARS customers was a top priority. The firms recognized that they had both a law enforcement problem and a business and reputation problem resulting from the freezing of the ARS market.

Early on, the SEC's staff, in coordination with the NYAG, took the lead in structuring, proposing, and negotiating the framework for a settlement that included liquidity solutions for tens of thousands of customers. This framework was developed in consultation with the SEC's Division of Trading and Markets, and included consultation with the Federal Reserve and other federal regulators to obtain their consideration on the potential impact that any settlement might have on the broader capital markets. Of paramount importance to the SEC's staff was providing quick liquidity solutions for retail customers, charities, and small businesses that were, from our perspective, most in need of access to their funds. The Enforcement Division's agreements-in-principle with UBS and Citigroup established a general framework for other firms' settlements.

While the SEC staff and NYAG took the initial lead in negotiating settlements with UBS and Citigroup, other state regulators--especially through NASAA under the leadership of its President Karen Tyler and its ARS Task Force, including Secretary William Galvin--quickly joined the efforts and brought their talents to bear on reaching global resolutions. Although negotiating the global settlements was not easy, all parties proceeded in good faith working virtually around the clock for weeks. All members of the enforcement teams felt that working together enabled us to maximize the relief provided to investors.

On August 7th and August 8th, the SEC's Enforcement Division, NYAG, NASAA, and the Massachusetts and Texas securities authorities announced settlements-in-principle with Citigroup and UBS, respectively. In pertinent part, both firms agreed to offer to purchase frozen ARS from retail customers, small businesses, and charitable organizations at 100 cents on the dollar and within short time frames.

In sum, customers who accept these offers will have received all interest payments or dividends and will be given the opportunity to sell their ARS at par, without a loss. Both firms will also make whole any losses sustained by customers who sold their ARS at less than par after the market freeze and will offer no-cost loan programs to certain eligible customers with immediate liquidity needs. The settlements also provide a mechanism, through FINRA, for customers to participate in a special arbitration process to pursue consequential damages. As for larger institutional investors, UBS has agreed to offer to purchase ARS at par over a longer time frame, while Citigroup has agreed to use its best efforts to provide liquidity solutions for its institutional customers. The SEC staff is now finalizing the settlement terms with the firms, which it intends to recommend to the Commission for approval.

In addition to the SEC's efforts with respect to UBS and Citigroup, SEC staff has continued to work quickly to complete investigations of other firms that sold ARS to their customers in potential violation of the securities laws. These other investigations have resulted in the SEC's Enforcement Division and the states reaching settlements-in-principle with Wachovia and Merrill Lynch. *See* Press Releases 2008-168 (Citigroup, Aug 7, 2008), 2008-171 (UBS, August 8, 2008), 2008-176. (Wachovia, August 15, 2008) and 2008-181 (Merrill Lynch, August 22, 2008).

Through the settlements with UBS, Citigroup, Wachovia, and Merrill Lynch, over $40 billion in liquidity will be made available to tens of thousands of customers in the near future. The goal of the SEC in these matters has been to return as much liquidity to investors as quickly as possible. The Enforcement Division's achievement of these unprecedented settlements within only six months after the ARS market froze -- thereby ensuring the return of over $40 billion in liquidity to investors -- represents substantial progress toward the attainment of that goal, while at the same time avoiding further disruption in the financial markets. The settlements-in-principle defer imposing financial penalties on the settling firms at this time to permit evaluation of, among other things, their performance under the settlements in restoring liquidity to their customers.

The SEC's investigations of the settling firms and many other firms are continuing. With respect to the settling firms, the focus of the investigations is shifting to the conduct of particular individuals. Investigations of other firms will encompass not only the conduct of the firms, but conduct of individuals as well. The Commission will seek to hold individuals accountable if they violated the federal securities laws. Individual accountability provides a additional and powerful deterrent to others on Wall Street who might consider engaging in similar improper conduct.

The SEC's May 2006 Enforcement Action

This is not the first time the SEC has brought enforcement actions involving ARS issues. The Commission brought prior enforcement actions against numerous broker-dealer firms relating to their failure to disclose certain of their practices in conducting ARS auctions. In May 2006, the Commission brought a settled administrative action against 15 broker-dealers for failing to disclose, among other things, that they bid to prevent failed auctions, submitted or changed orders after auction deadlines, and favored certain preferred customers by giving them an informational advantage in the bidding process.

In its May 2006 Order, the Commission noted that as a result of certain of these undisclosed practices, investors may not have been aware of certain liquidity risks. The May 2006 Order required that the firms provide all customers and all broker-dealers purchasing ARS with a written description of the firms' material auction practices and procedures. The May 2006 Order, with its requirements to disclose material auction practices, caused firms to disclose that the firms bid in the auctions to prevent failed auctions from occurring because this is a material auction practice. Subsequently, SIFMA developed guidance for its members that contains such sample ARS disclosure.

The firms certified to the Commission that they had implemented procedures to ensure that their auctions were conducted in accordance with the disclosures. In fact, the CEOs or GCs for these firms provided written certifications to the staff of the Commission that the firms had implemented procedures that were reasonably designed to prevent and detect failures by the firms to conduct the auction process in accordance with the auction procedures disclosed in the disclosure documents and any supplemental

disclosures and that the firms complied with the written notification requirements of the Order.

The current investigations and examinations, unlike the prior Commission investigation, focus not on the auction process but rather on the marketing of the securities.

The SEC Took Important Regulatory Action to Address Disruptions in the ARS Market

As I mentioned at the outset, the SEC's efforts have involved not only the Enforcement Division but other Divisions and Offices as well, including most notably the Office of Compliance Inspections and Examinations, the Office of Investor Education and Advocacy, the Division of Investment Management, and the Division of Trading and Markets.

For example, as this Committee knows from the past testimony of Erik Sirri, Director of the Division of Trading and Markets, Commission staff worked quickly to help provide market liquidity by issuing a no-action letter on March 14, 2008 allowing municipal issuers to purchase their own ARS provided certain conditions and disclosures were followed. Public sector borrowers have now refinanced or made plans to refinance at least $103.7 billion of the originally-outstanding $166 billion in municipal auction-rate debt, or 62 percent, according to data compiled by Bloomberg News.[1] In addition, an index of the yields on auction-rate securities fell to 2.98 on September 10 from as high as 6.89 on February 20.[2]

Moreover, the SEC's Division of Investment Management has been working with closed-end funds that issued auction rate preferred stock (ARP) and broker-dealers that sold ARP to retail customers to restore liquidity to those holders. At the beginning of 2008, ARP issued by closed-end funds accounted for about 20% of the $330 billion ARS market. As of September 12, 2008, closed-end funds had redeemed, or announced specific plans to redeem, about 40% of the $64 billion of ARP outstanding before the auction failures in February. The staff has issued a no-action letter and is considering additional actions to assist funds in the process of restoring liquidity.

Some funds have also applied to the Commission for temporary exemptive relief from the Investment Company Act of 1940 to allow them to issue debt, the proceeds of which would be used to repurchase their outstanding ARP. The relief, if granted would apply for a period of two years. The Commission is currently considering that request for exemptive relief and anticipates taking action on it soon.

The SEC's Enforcement Mandate

[1] Michael Quint, "Government Payments to Wall Street for Auction-Rate Wreck Climb," Bloomberg News September 9, 2008.
[2] See http://www.sifma.net/story.asp?id=1882

While the Commission has devoted substantial nationwide resources to the ARS investigations and settlements -- as I mentioned we have dozens of staff professionals working on ARS throughout the country -- we continued to bring many other important cases in all of the Commission's program areas. Indeed, one of the Commission's most pressing priorities over the past two years has been the investigation of matters arising out of the subprime mortgage and credit market crisis, which continues to unfold.

In early 2007, the Enforcement Division created a Subprime Working Group to coordinate numerous enforcement investigations across the country relating to various aspects of the subprime crisis. In January 2008, Chairman Cox created a Commission-wide Subprime Task Force to coordinate the SEC's multifaceted efforts to address the current crisis, including both regulatory and enforcement initiatives, and to facilitate the SEC's continuing cooperation with other state and federal law enforcement agencies.

The Enforcement Division's Subprime Working Group is presently conducting more than 50 investigations in the subprime area, exclusive of ARS. They fall primarily into three broad categories: first, those involving subprime lenders; second, those involving investment banks, credit rating agencies, insurers and others involved in the securitization process; and third, those involving banks and broker-dealers who sold mortgage-backed investments to the public. At the same time that we were investigating and negotiating settlements in the recent ARS cases, we also brought a number of critically important subprime enforcement actions:

- In April 2008, just a few weeks after the demise of Bear Stearns, the Commission brought a landmark enforcement action alleging market manipulation based on circulation of false rumors as part of a short-selling scheme. This case reflects the SEC's concern that possible market manipulations involving the circulation of false rumors and related short selling may have contributed to an increase in market volatility during the subprime and credit markets crisis, which is impacting many ordinary investors. Our first enforcement action involving such rumors alleged that a trader manipulated the market in the stock of a public company by sending instant messages to brokerage firms and hedge funds containing false information about a pending acquisition. The false rumors caused the company's stock to drop by 17%, and wiped out $1 billion of market cap in the first 30 minutes. Following our enforcement action, the Commission not only imposed penalties and other sanctions on the trader, but also banned him from the industry for life.[3]
- In June 2008, the Commission brought enforcement actions against two former portfolio managers of Bear Stearns Asset Management, whose two largest hedge funds had collapsed in the summer of 2007, causing more than $1.8 billion in investor losses. We allege that the portfolio managers deceived their investors and institutional counterparties about the financial state of the hedge funds, and in

[3] *SEC v. Paul S. Berliner*, Lit. Rel. No. 20537 (Apr. 24, 2008).

particular the hedge funds' over-exposure to subprime mortgage-backed securities.[4]

- On September 3, 2008, the Commission brought an enforcement action involving both the subprime and ARS areas. The Commission charged two Wall Street brokers with defrauding customers in connection with their sales of more than $1 billion in unauthorized subprime-related ARS. The brokers allegedly misled their customers into believing that certain ARS purchased for their accounts were backed by federally-guaranteed student loans, and were a safe and liquid alternative to bank deposits and money market accounts. Instead, the securities the brokers purchased for their customers were backed by subprime mortgages, collateralized debt obligations (CDOs), and other non-student loan collateral. The brokers allegedly went so far as to add the words "student loan" or "education" to the names of the non-student loan securities listed in trade confirmations emailed to customers, and to delete the words "mortgage" and "CDO" from the names of such securities. When the ARS market froze, the ARS purchased for the customers became illiquid, and the subprime-mortgage backed securities have since declined substantially in value.[5]

Aside from our ARS and subprime cases, the SEC has continued in its mission of enforcing the federal securities laws across the broadest possible spectrum of potential violations. Since the ARS market froze in mid-February 2008, the Commission has brought a total of approximately 385 enforcement actions. Aside from ARS, other noteworthy accomplishments include enforcement actions brought in the areas of:

- Illegal stock option backdating
    - Since mid-Febuary 2008, the SEC has brought 27 new cases alleging illegal stock options backdating; 7 of them were settled actions against corporations and 20 of them were cases against individuals, including 6 CEOs, 3 CFOs and 3 General Counsel.[6]
- Financial fraud
- Violations of the Foreign Corrupt Practices Act, which prohibits U.S. companies and their employees from bribing foreign government officials to obtain business
    - Together with the U.S. Department of Justice, the SEC is on track to file a record number of enforcement actions this year based on the FCPA. Most recently, the Commission on September 3, 2008, filed an enforcement action against Albert Stanley, the former CEO of Kellogg, Brown & Root, in connection for alleged bribery

[4] *SEC v. Ralph R. Cioffi and Matthew M. Tannin*, Lit. Rel. No. 20625 (Jun. 19, 2008).

[5] *SEC v. Julian T. Tzolov and Eric S. Butler*, Lit. Rel. No. 20698 (Sept. 3, 2008)

[6] *See, e.g.*, *SEC v. Broadcom*, Lit. Rel. No. 20532 (Apr. 22, 2008); *SEC v. Analog Devices, Inc.*, Lit. Rel. No. 20604 (May 30, 2008).

of Nigerian government officials to obtain construction contracts worth more than $6 billion.[7]

- Ponzi schemes
    - Notably, the Wextrust case involved a series of fraudulent offerings; the defendants raised $255 million, primarily from members of the Orthodox Jewish community, which they purportedly used for investments in commercial real estate ventures, but which in reality they used to pay returns to investors in prior offerings or to pay their own expenses.[8]
- Other affinity frauds, which prey on the trust between individuals in a group
    - As examples here, we stopped a fraudulent real estate investment scheme that targeted the African-American community and that was marketed on the basis of other people's subprime mortgage woes. The promoters claimed they used $18 million in investor funds to cure defaults on distressed properties and promised returns of 50% over 30-45 days, when in reality the funds were used to pay the promoters' personal expenses, including a lavish wedding, cars, jewelry, entertainment and home renovations.[9]
    - We also obtained a final judgment against a multi-level marketing scheme that sought to exploit Christians, which required the promoters to pay nearly $8 million in disgorgement and civil penalties. In this case, the promoters—one of whom held himself out as an ordained minister—ran a purported commodities futures trading scheme in which they encouraged investors they designated as "consultants" to solicit new investors from among fellow church members and other self-identified Christians. The promoters improperly diverted the investors' funds to themselves and entities they controlled.[10]
- Money laundering
- Insider trading cases
    - Our cases here include actions against a broad range of defendants, including: the former Chairman and CEO of Enron Energy Services; a former partner at the accounting firm of Ernst & Young; three Ft. Lauderdale doctors; and the mayor of Beaufort, South Carolina.[11]
- Internet frauds

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[7] *SEC v. Albert Stanley Jackson*, Lit. Rel. No. 20700 (Sept. 3, 2008).

[8] *SEC v. Steven Byers, et al.*, Lit. Rel. No. 20678 (Aug. 11, 2008).

[9] *SEC v. Jeanetta M. Standefor, et al.*, Lit. Rel. No. 20575 (May 14, 1008).

[10] *SEC v. Alanar, Inc.*, Lit. Rel. No. 20629 (Jun. 25, 2008).

[11] *SEC v. Lou L. Pai*, Lit. Rel. No. 20658 (Jul. 29, 2008); *SEC v. Zachariah P. Zachariah, et al.*, Lit. Rel. No. 20564 (May 12, 2008); *SEC v. William J. Rauch*, Lit. Rel. No. 20646 (Jul. 16, 2008).

- Municipal bond frauds

During the same time period, the Commission has also distributed approximately $700 million to injured investors in disgorgement and civil penalties paid in prior enforcement actions.

While ARS and subprime issues related to the recent market turmoil have captured significant attention over the past year, the SEC's enduring mission in securities law enforcement is to be vigilant in addressing the broadest possible range of potential violations at all times. Some of our enforcement actions make headlines, but the vast majority of our cases do not and yet, collectively, they are no less important to the integrity of our markets and investors' confidence in them. Though our enforcement priorities change to meet new challenges in the markets, the core of our daily enforcement work remains the same. We seek to cover the entire waterfront in the securities markets—combating accounting fraud, market manipulations, offering frauds and insider trading, among other things, all across the nation every day. It is our privilege to work for investors.

Conclusion

I want to thank you for this opportunity to discuss the Commission's efforts with respect to the ARS market. I would be happy to answer any questions you may have.